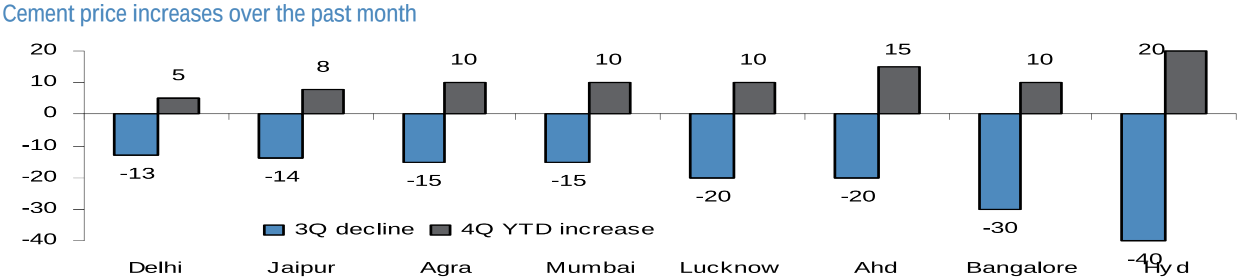
India Cement

3Q results review: Sharp decline in realizations – is the recent price recovery sustainable?

Majority of the cement companies have reported 3Q earnings. We discuss the key takeaways from various conference calls and comments on the outlook.

- **Was Dec-09 the worst quarter for the current down-cycle?:** Most cement companies, especially the Southern India-based companies (for which price drops were more pronounced), highlighted that: (a) they currently see an improved demand outlook, particularly in AP; and (b) at November price levels, many of the smaller cement companies in AP were either loss-making/close to loss-making at the operating level (refer to page 5 for our detailed takeaways from each company's conference call.). **However, we disagree with this conclusion, given that over the next 3-6 months, at least 40MT of capacity is likely to be added to the current nameplate capacity of 235MT**. **While in the Dec-09 quarter, pricing pressure was primarily observed in Southern India, with AP being the epicenter, we believe over the next 12 months the pricing pressure will be more broad-based, with Northern/Western India facing pressure, given the wave of capacity will restart. Dalmia Cement (Not Rated) summed up its outlook by saying, "We expect volatility in cement prices over the next 18 months".**
- **Prices appear to be recovering in the seasonally strong March quarter; production cuts were seen in December:** Cement prices have increased over the past month—most increases have taken place in AP (where prices fell the most and are now up by Rs20-25/bag), while more modest price increases are being observed across Western and Northern India (Rs10-15/bag). While infrastructure bottlenecks have likely added to the strong demand, large production cuts were observed, particularly in AP, in Dec-09 (Sagar Cements highlighted that in the Dec-09 quarter it operated at a 50% utilization level, which has now increased to 100%).
- **While March quarter likely to see better results than 3Q, problems could resurface from May-June; companies expect coal costs to be materially higher:** The Q/Q EBITDA/MT should improve, given cement prices have increased. Most cement companies reported imported coal costs of US$70-80/MT CIF in December, which have now risen to US$120/MT; this could affect earnings in the June quarter. Also, we expect excise rates to increase in this year's budget.
- **'Production discipline', which is still difficult to call, should determine the decline in cement prices after the seasonally strong March quarter.**

Cement price increases over the past month



Source: J.P. Morgan estimates, based on our dealer checks.

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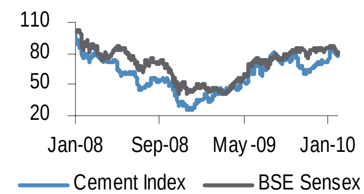
J.P. Morgan Cement Index performance vs BSE 30



Source: Bloomberg, Priced as of Jan 28, 2010.

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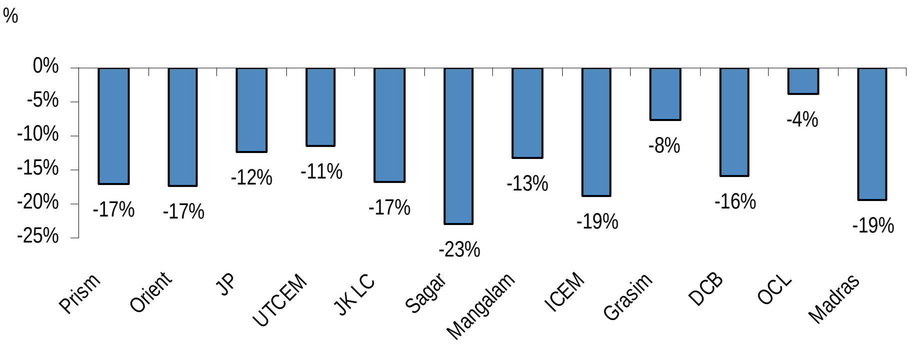
December quarter: Sharp differential price declines across the board

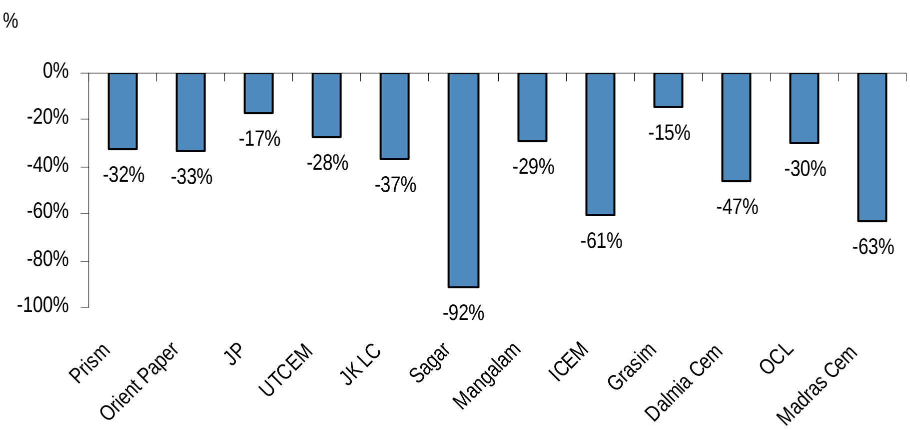
So far, the results of cement companies have largely pointed to varying levels of decline in realizations based on their catchments of operation. As we expected, Southern India-based companies (particularly AP) experienced a larger impact from steep price declines and lower volumes than others. Supplies into the new markets with higher realizations (especially by Southern India companies) were evident from the increase in the lead distance. Although most of the companies have seen a recovery in prices since mid-December, prices are still below the September 2009 levels. Currently, the companies observe improving demand trends, particularly in Southern India, and expect prices to remain stable/improve in 4Q FY10. The EBITDA/MT declined in December, with most companies reporting 20-30% Q/Q declines in profitability.

Figure 1: Cement realizations declined Q/Q in 3Q FY10



Source: Company reports.

Figure 2: Cement EBITDA/MT declined in 3Q FY10



Source: Company reports.

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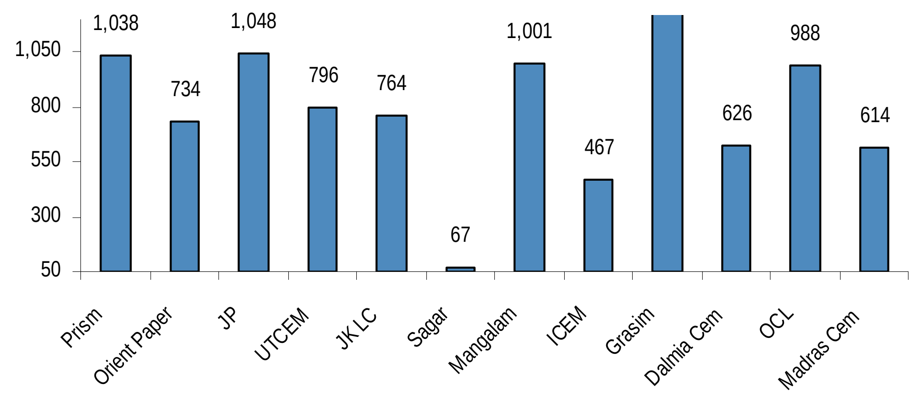
Figure 3: Cement EBITDA/MT in 3Q FY10

Rs/MT

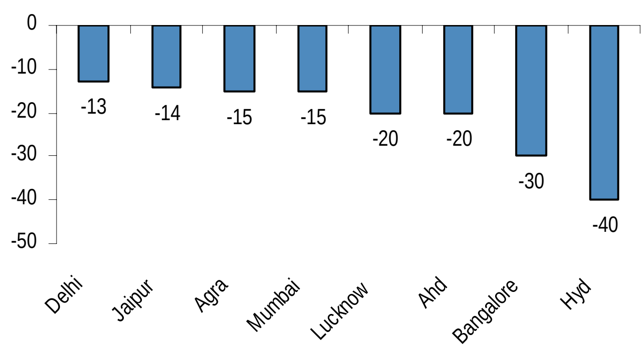


Source: Company reports and J.P. Morgan estimates.

Will the price recovery be sustained? We believe problems will resurface from May-June 2010

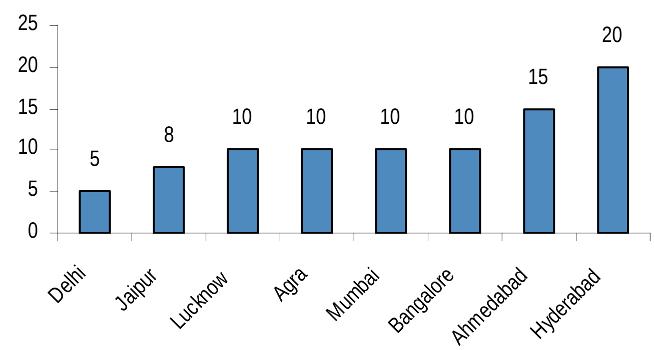
Cement demand recovered sharply in Dec-09, driven by a rebound in government spending and release of funds, particularly in Southern India. Given the potential capacity additions/ramp ups over the next six months, we believe for cement pricing strength to continue, we need to see strong production discipline (similar to what was seen in AP in the Nov/Dec 2009 period). We expect Northern India to see pricing pressure given the wave of capacity commissioning, including, Shree Cements, Grasim, Ambuja and Jaiprakash.

Figure 4: Cement prices declined sharply in 3Q FY10...



Source: J.P. Morgan estimates, based on our dealer checks.

Figure 5: ...but prices have improved in 4Q



Source: J.P. Morgan estimates, based on our dealer checks.

Table 1: India cement demand and capacity outlook

MT	FY05	FY06	FY07	FY08	FY09	FY10E	FY11E	FY12E
Available capacity for the year	150	156	165	173	205	237	261	273
Year-end capacity	152	160	166	189	212	254	269	279
Capacity addition on available basis	6.2	5.7	8.9	8.5	*31.6*	*32.0*	*24.0*	*10.5*
Capacity addition on end basis	7.1	8.1	5.9	23.2	22.9	41.7	15.0	6.5
Domestic demand	121	135	148	163	178	193	210	230
Demand growth (%)	6.7	11.5	10.0	10.1	8.8	8.5	9.0	9.0
Exports	10.1	9.2	8.9	5.9	6.0	6.0	6.0	5.0
Growth (%)	12.2	-8.9	-3.3	-33.7	1.7	0.0	0.0	0.0
Total demand	131.0	144.1	157.2	169.2	183.7	198.8	216.2	234.9
Growth (%)	7.1	9.9	9.1	7.6	8.6	8.2	8.7	8.8
Cap util - Available capacity (%)	87	93	95	98	90	84	83	86

Source: CMA and J.P. Morgan estimates.

Table 2: Capacity addition over the next six months

Company	Current capacity	Capacity (MT)	2Q FY11E capacity	Location	State	Timeline
North						
Jaypee		1.8		Bageri	HP	4QFY10
Shree Cement		1.5		Suratgarh	Rajasthan	4QFY10
Shree Cement		1.0		Rourkee	Uttaranchal	4QFY10
Grasim		4.5		Kotputli	Rajasthan	4QFY10
Ambuja		2.2		Rauri	HP	1QFY10
Total	59.8	11.0	70.7			
West						
Jaypee		1.2		Kutch	Gujarat	4QFY10
Murli Industries		3.0		Chandrapur	Maharashtra	1QFY10
Jaypee		2.8		Bhuj	Gujarat	2QFY10
Total	67.4	7.0	74.4			
East						
ACC		1.2		Bargarh	Orissa	1QFY11
Ambuja		2.2		Bharatpur	Chhattisgarh	4QFY10
Total	21.9	3.4	25.3			
South						
JKCement		3.0		Mudhol	Karnataka	4QFY10
ACC		2.6		New Wadi	Karnataka	4QFY10
Zauri		2.2		Yerraguntla	AP	4QFY10
Andhra Cem		2.1		Visakhapatnam	AP	4QFY10
Madras Cem		2.2		Kistna	AP	1QFY11
Chettinad Cement		2.0		Ariyalur	TN	1QFY11
Jai Jyoti		2.0			AP	1QFY11
Total	84.8	16.3	101.1			
India - Total	233.9	37.7	271.9			

Source: Company reports and J.P. Morgan estimates.

Key Industry highlights:

a) Wide disparity in profitability in Southern and non-Southern India companies: Southern India-based companies reported a far higher drop in realizations and profitability/MT compared to Northern India-based companies. However, companies with exposure to the Central Indian state of UP also saw sharp declines. Pure AP-based companies, such as Sagar Cements (Not Rated), reported losses at the PAT level.

b) Demand recovery seen since December, particularly in AP: Demand commentary was positive with all companies pointing to a demand recovery, particularly since December, driven by a pickup in government disbursements. AP, which bore the brunt of capacity commissioning and weak demand, due to political instability, experienced a demand recovery driven by the restart of irrigation projects and low-cost housing projects. Seasonally, the March quarter is the peak quarter for cement demand, and we expect robust demand to continue in the near term.

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c) Terms of trade seeing a change with more credit period: While this was not a consensus takeaway, smaller companies highlighted that the credit period in the non-trade segment has seen a very sharp increase—the credit period currently is 90 days, compared to the earlier practice of cash and carry.

d) Freight cost increase across the board was driven by higher lead distances.

e) Capacity additions over the next six months should be in the range of 35-40MT.

Key takeaways by company:

Prism Cement (Not Rated): The MP-based cement manufacturer started the 3Q FY10 earnings season for the sector with weak results. The company reported a 17% Q/Q decline in realizations and a 32% decline in EBITDA/MT. Its key markets, MP and neighboring areas in UP, Bihar, Jharkhand and Chhattisgarh, witnessed lower price reduction than the Southern India markets. The company is currently in the process of increasing its capacity over the next 12 months, with the commissioning of a 3.6MT plant close to its existing facility in Satna, MP.

JK Lakshmi (Not Rated): The company, with its key markets in Western and Northern India, reported a 17% Q/Q decline in realizations, driving an 800bp decline in EBITDA margin. According to management, prices fell about Rs18/bag in the 3Q. While prices have increased by Rs10/bag in Gujarat and Maharashtra and Rs5-7/bag in North India in the trade segment, the non-trade prices continue to lag and are expected to improve over the near term, according to the company. Management confirmed that railway movement had been an issue during the December quarter, limiting cement supply and firming prices.

Sagar Cement (Not Rated): The AP-based cement company was the first company to report a PAT loss in the Dec-09 quarter; it bore the brunt of being located at the heart of the oversupply problem in AP. Its realizations for the quarter declined sharply (23% Q/Q). Management highlighted that on an NSR basis, realizations touched a low of Rs1700/MT in the December quarter (declining Rs600/MT from 2Q FY10) with current average realizations of Rs2100/MT. The company's capacity utilization fell to 50% (given higher clinker stocks)—lower than the 60-65% cash profit breakeven level of cement prices at Rs1700/MT. However, utilization in Jan-10 has reached 100% levels. Freight costs were higher as lead distance for dispatches increased with materials traveling to markets as far as Assam.

Management also threw light on the demand outlook in the AP market, which has been affected by political instability. According to the company, cement demand improved through the quarter, with strong demand in Dec-09 as several government projects (irrigation and low cost housing) restarted and are picking up pace. However, the company highlighted the continued oversupply situation in the market with additional capacity of 10-12MT (Zuari, Jai Jyoti) hitting the market by 1H FY11.

India Cement (Not Rated): One of the large cement companies of Southern India. The company's realizations declined 19% Q/Q as prices fell in most of its markets. Prices reached lows of Rs140/bag in Hyderabad, and Rs200/bag in TN. According to the company, the worst is over for price declines in Southern India as the full impact from higher capacity addition has taken place. The price recovery seen since December (Hyderabad prices rose Rs10/bag and prices in Karnataka and TN rose Rs15-20/bag) is likely to stay over the next few months. Management expects a recovery in cement prices in FY11, driven by higher demand in Southern India markets. According ICEM's management, AP should see a 10-11% growth in demand, driven by government spending on low-cost housing.

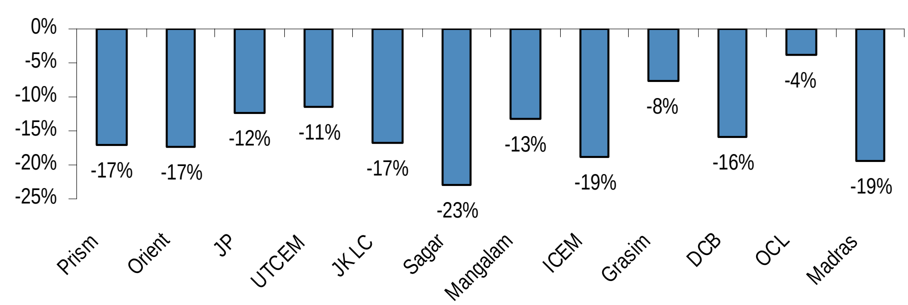
The company expects new capacity addition in Southern India is most likely to come into the market in 2H FY11, which should be absorbed by a demand recovery. The average lead distance was 500km as the company moved supplies to markets such as Bihar, WB, and Assam, which had better realizations. Given the high proportion of import coal in its mix (55% of requirement), higher coal costs (US$90-95 CIF versus US$117 for current imports) could impact the company in the later half of 4Q FY10, according to management.

Shree Cement (Not Rated): For the Northern India-based cement company, realizations dropped only 5.2% Q/Q, well below many of its peer, but prices have recovered since mid-December. The company also pointed out that demand in its markets had surprised and therefore, it believes the large capacity addition in its market is likely to limit any pricing pressure. The company expects capacity to increase by 12.8MT in the last quarter of FY10 in its catchment area (including 3.6MT of grinding capacity) and 44MT of capacity in Pan India (western, 7.1MT; southern, 14.3MT; eastern, 7.2MT; central, 2.5MT, and northern, 12.8MT).

Dalmia Cement (Not Rated): Dalmia Cement is a Southern India-based company, with significant exposure to TN and Kerala. After its capacity expansion, the company expanded distribution to AP and Karnataka. Its realizations declined nearly 16% sequentially in 3Q with EBITDA/MT halving to Rs629/MT from its peak. Management pointed to seasonality (monsoon in Southern India) and weak market conditions for the deterioration in realizations. However, management appeared positive on the demand recovery in Southern India and believes that political stability in AP and Karnataka will shift focus back to infrastructure development in these markets, driving cement consumption. Industry capacity utilization will be close to 80%, according to the company.

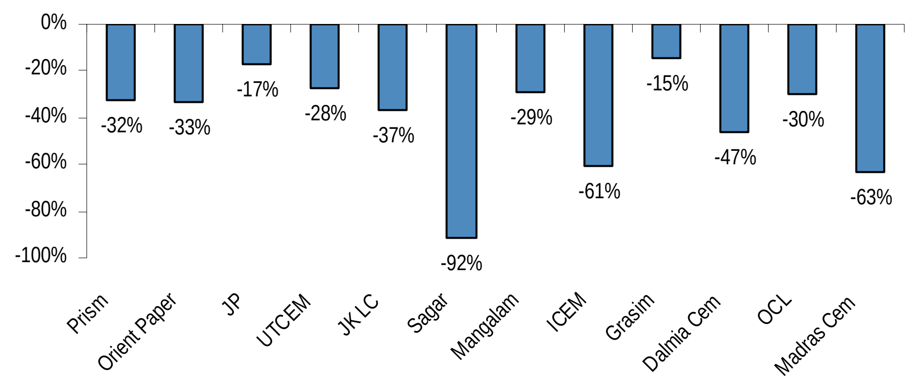
On the pricing outlook, management expects prices to remain firm in the near term due to seasonality and demand growth. But the company warned of volatile pricing over the next 18-24months, given the capacity addition. Dalmia estimates capacity addition of close to 23MT in the next quarter with 11MT in Southern India and 6MT in Eastern India. Management said, DCB is expanding capacity by 10MT in phases and the average replacement cost for the expansion was US$100-110/MT. Like its peers, Dalmia estimates an increase in coal cost from an average cost of US$84 CIF in 3Q to US$100 currently, driven by a sharp increase in coal prices.

Figure 6: Cement realizations declined Q/Q in 3Q FY10



Source: Company reports.

Figure 7: Cement EBITDA/MT also declined in 3Q FY10



Source: Company reports.

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